08-1928
AUDIT
SIGNED 08-11-2010

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2 Petitioners, vs. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW AND FINAL DECISION** Appeal No. 08-1928 Account No. ##### Tax Type: Income Tax Tax Years: 2005 Judge: Phan

Presiding:
Michael J. Cragun, Commissioner
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP.
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on December 7, 2009, pursuant to Utah Code Secs. 59-1-501 and 63G-4-201 et al. The Commission then requested that the parties provide posthearing information as well as a posthearing brief. Petitioners (the "Taxpayers") responded to the request for information on February 24, 2010. Respondent (the "Division") did not submit a reply to that information. The Division submitted its post hearing Supplemental Brief of Auditing Division on May 11, 2010 and the Taxpayers a reply on May 20, 2010. Based upon the evidence and testimony presented at the hearing and the post hearing submissions, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The Taxpayers are appealing an individual income tax audit deficiency for the tax year 2005. The Taxpayers had timely appealed the audit and the matter proceeded to this Formal Hearing. The issue contested by the Taxpayers is the Division's disallowance of an Enterprise Zone Credit that the Taxpayers had claimed on their joint Utah Individual Income Tax Return. The Taxpayers had claimed a total of $$$$$ in enterprise zone credits for the 2005 tax year. The Division disallowed $$$$$ of the credits, which gave rise to

an audit deficiency. Interest was assessed with the audit. No penalties were assessed.

2. For their 2005 tax filing, the Taxpayers had claimed income and expenses from pass through entities COMPANY A ("COMPANY A") and COMPANY B ("COMPANY B") of which they were members.

3. The Taxpayers' representative testified that these two business entities were essentially working together, with another entity, to support one manufacturing operation. However, the operations, assets and liabilities had been separated into different legal entities for liability reasons.

4. There was no dispute that these two entities, COMPANY A and COMPANY B, were separate legal entities with separate tax identification numbers.

5. From the facts presented, which were unrefuted, COMPANY A was the entity that had employees. It hired and paid the employees. COMPANY A also leased the facilities where these employees were employed. It was not refuted that more than 51% of COMPANY A's employees during the tax year were residents of the county in which the enterprise zone was located.

6. During 2005, COMPANY A hired additional employees and COMPANY A qualified for an Enterprise Zone Credit on these new hires. The amount of this credit passed through to the Taxpayers' return related to the employee hires had been the $$$$$ that was allowed by the Division.

7. During 2005 COMPANY B purchased equipment that was the basis for that entity claiming an additional Enterprise Zone Credit under the provisions of §63-38f-413(g). The amount of this credit passed through and claimed by the Taxpayers on their 2005 return had been $$$$$. This is the portion of the credit that the Division disallowed in the audit. The reason given by the Division for the disallowance was that COMPANY B did not qualify for the Enterprise Zone Credit because it had no employees.

8. The Taxpayers did not refute the contention that COMPANY B had no employees.

9. Although the employees were employees of COMPANY A, the building in which they worked and in which the manufacturing operations occurred, was owned by a third legal entity, COMPANY C ("COMPANY C"). COMPANY C was owned by the same parties as COMPANY A and COMPANY B. However, COMPANY C leased the building to COMPANY A. Additionally, COMPANY B leased equipment to COMPANY A.

APPLICABLE LAW

The law in effect for tax year 2005 provides Enterprise Zone Credits when businesses meet specified requirements. The provision that is at issue in this matter is Utah Code Ann. §63-38f-412(2005), which states:

> The tax incentives described in this part are available only to a business firm for which at least 51% of the employees employed at facilities of the firm located in the enterprise zone are individuals who, at the time of employment, reside in the county in which the enterprise zone is located.

Utah law provides that the income and expenses of a partnership pass through to the partners at Utah Code Sec. 59-10-301 which states:

> A partnership is not subject to the tax imposed by this chapter. Persons carrying on business as partners are liable for the tax imposed by this chapter only in their separate or individual capacities.

The statute in effect during the 2005-year prescribed the allocation of the partnership income at Utah Code Sec. 59-10-302 (2005) as follows:

> Each item of partnership income, gain, loss or deduction has the same character for a partner under this chapter as it has for federal income tax purposes. When an item is not characterized for federal income tax purposes, it has the same character for a partner as if realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

DISCUSSION

The reason given by the Division for denial of the COMPANY B credit was its interpretation that that under Utah Code Sec. 63-38f-412, the entity claiming the credit must have employees to qualify for the credit. Further, regarding the employees, at least 51% must be residents of the county in which the enterprise zone was located. COMPANY A met this requirement and for that reason the Division had allowed the Enterprise Zone Credit that COMPANY A had claimed for the new employees. However it was undisputed that the separate legal entity COMPANY B had no employees and for this stated reason the Division disallowed the credit claimed by this entity.

There is no dispute that COMPANY A, COMPANY B and COMPANY C are all separate legal entities. Additionally, the Commission agrees that they are separate "firms" within the meaning of the income tax statutes. See *SF Phosphates, Ltd. V. Auditing Division*, 972 P.2d 384 (Utah 1998). The Commission further agrees that those entities are all taxpayers for purposes of the sales tax and that any sales between the entities would be subject to the sales tax laws of the state. See *SF Phosphates; Thurup Bros. Construction, Inc. v Auditing Division*, 860-P.2d 324 (Utah 1993); *Institutional Laundry, Inc. v. Utah State Tax Commission*, 706 P.2d 1066 (Utah 1985).

However, this appeal is not dealing with sales tax. This is an income tax appeal dealing with entities whose incomes and liabilities are passed through to the individual taxpayers.[1] Utah Code Ann. §59-10-301 provides that partnerships, including limited liability companies classified as partnerships for tax purposes, are not subject to the individual income tax. The taxpayers in this case are not the COMPANY A, COMPANY B, COMPANY C entities, they are two of the individual members of the COMPANY A, COMPANY B, COMPANY C LLC's.

Section 59-10-302 provides that an item "has the same character for a partner as if realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." Although the Taxpayers did not hire anyone, they are treated as if they had incurred those expenses, thus making them eligible for the employee tax credit. The Division concedes that the Taxpayers are eligible for the employee credit. They are also treated as though they incurred the expenses to purchase the equipment, allowing them to claim depreciation and other expenses related to the equipment on their personal tax returns. Furthermore, the Taxpayers are treated as though they had acquired the building directly, thus qualifying them to claim those depreciation deductions.

Because the Taxpayers are treated for income tax purposes as if they had hired the employees, as if they had purchased the equipment, and as if they had purchased the facilities at which the employees are employed and the equipment is utilized, they qualify for the enterprise zone credit. The Commission does not believe that a different result is required just because the Taxpayers utilized three LLC's instead of one.

The Commission recognizes that this conclusion is different than the conclusion in Appeal No. 98-1062. However, §59-10-302 was not discussed in that opinion. The Commission recognizes that exemptions and credits are to be construed narrowly against the taxpayer. See *SF Phosphates, supra*. They must also be construed, however, in a manner that is in harmony with the legislative intent in granting the deduction or credit. Cf. *Eaton Kenway, Inc. v. Auditing Division*, 906 P.2d. 882 (Utah 1995). The Taxpayers' investment in the Enterprise Zone, and their employment of residents of the county in which the zone was located, albeit through different pass-through entities, is exactly the type of investment the legislature sought to encourage. The Commission, therefore, allows the credit.

CONCLUSIONS OF LAW

Section 59-10-302 provides that an item "has the same character for a partner as if realized directly

1 The facts in this appeal are further distinguished from those in *SF Phosphates,* which involved a sales tax to the corporate entities. That case did not address pass through entities with the tax at issue being individual income tax, as is in this appeal now before the Commission.

from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." Under this section the Taxpayers are treated for income tax purposes as if they had hired the employees, purchased the equipment and operated the facilities at which the employees are employed. Therefore, they qualify for the enterprise zone credit.

DECISION AND ORDER

Based on the foregoing, the Commission abates the audit deficiency against the Taxpayers in this matter for the tax year 2005. It is so ordered.

Dated this _____ day of _____, 2010.

R. Bruce Johnson
Commission Chair

Michael J. Cragun
Commissioner

CONCURRENCE

We disagree with the majority's analysis, but concur with the outcome only for the year in question. We would deny the credit prospectively from the date the order was issued, but the law was changed[2] and the underlying statute would not have been applicable for subsequent years.

We are required to strictly construe statutory language against granting credits. *MacFarlane v. State Tax Comm'n*, 134 P.3d 1116 (Utah, 2006). Section 63-38f-412 provides that "[t]he tax incentives under this part are only available to a business firm. . . ." (Emphasis added.) No provision allows for a credit to be available to a different entity even when a firm works together with other firms to support one operation. Nothing in the statute provides for a credit to be available to owners of a firm when the firm has no tax liability. However, § 63-38f-413(1), provides that "state credits against individual income taxes . . . are applicable in an enterprise zone." Therefore, the Taxpayers may claim credits against their individual income taxes, but only for those credits that are available to a qualifying firm subject to the provisions § 63-38f-412.[3]

2 In 2006 the statute was revised to provide that the credits were only available to "a business entity." See Utah Code §63M-1-412. In the 2006 revisions "business entity" was then defined at Utah Code §63M-1-402. However, these provisions were not in effect for the period at issue and my decision is based on the 2005 provisions of the code.

3 The credit is available to a firm, but applicable against taxes. If an entity does not pay taxes, the credit may be claimed by a party that does pay the taxes, even if that entity is not a firm.

Accordingly, since it has no employees, the credit is not available to COMPANY B as a single entity firm. COMPANY B and COMPANY A would have to be parts of, or entities within, a single firm in order to have the credit available to COMPANY B.

Neither party made a substantial effort or argument to define what constitutes a firm. The Taxpayers argue that the LLC's, COMPANY A and COMPANY B, work together to support the manufacturing operations. They contend that both LLC's, along with a third entity, COMPANY C, are owned by the exact same interest and are at the same location, and therefore qualify for the credit. They made no attempt to argue that COMPANY B qualifies because it is part of a firm.

The Division's position is that COMPANY A and COMPANY B are separate "entities," and therefore must be considered independently when determining if they qualify for the credit. In a supplemental brief, the Division cited the *SF Phosphates* court decision to support its position. That ruling is not dispositive for the present case; the circumstances are distinct from, and in stark contrast to, *SF Phosphates*. The issue before the court in *SF Phosphates* was whether a mining company should charge sales tax on fuels sold to a "loosely related" pipeline company, of which the mining company held 98% ownership. The companies in the present case are closely intertwined LLC's, not loosely related corporations, and the tax is income tax, not sales tax. The transaction in *SF Phosphates* is an intercompany sale of electricity; this appeal involves an income tax credit. The court upheld the Tax Commission's position, that the two corporations could not be considered to be a single firm, as "reasonable." Finally, the Court also upheld held the Commission's interpretation of its own rule. The Court did not rule conclusively that separate business entities could not constitute a single firm in all circumstances.

In the absence of persuasive evidence from either party, the underlying nature of COMPANY B, as well as the definition of "firm," must be considered to determine whether COMPANY B qualifies for the credit. Sections, 63-38f-412 and 413, provide for distinct results. The first makes the credit available to a specific entity, a "firm," while the other allows other related entities, including individuals and "businesses", to claim a credit against their taxes. Section 63-38f-413 uses only the term "business," to describe a business entity that may claim a credit; it does not reference the word "firm". Although the terms "firm" and "business" are commonly used, little exists in the way of legal authority to define them. The Court has defined "firm" in *SF Phosphates* as "'a business unit or enterprise,' an 'unincorporated business' or a 'partnership of two or more persons.'" . . . (Black's Law Dictionary 578 (5th ed. 1979)).[4] The same edition of *Black's* defines "business"

4 The primary issue addressed in *SF Phosphates* was not the definition of firm.

as "[e]mployment, occupation, profession, or commercial activity . . ." (Ibid. 179). These definitions are consistent with common and business usage, as well as with other sources, including the current edition of *Black's*. Although the two definitions may overlap, the terms are not necessarily synonymous. "Firm" is more specific, referring to the organizational elements of a company; while "business" is a broader, more general term, referring to the commercial undertaking of a company. The distinction between the two words[5] is in keeping with the legal requirement to avoid ambiguity. See *Morton Int'l, Inc. v. Auditing Div. of Utah State Tax Comm'n*, 814 P.2d 581, 590 (Utah 1991); *US Express v. Utah State Tax Comm'n*, 886 P.2d 1115, 1117 (Utah Ct. App. 1994). *Miller Welding Supply, Inc. v. Utah State Tax Comm'n*, 860 P.2d 361, 362 (Utah Ct. App. 1993), cert. denied, 870 P.2d 957 (Utah 1994). To read both terms as synonymous could result in ambiguity.

After considering the definitions of the two terms, it is questionable if COMPANY B is even a firm at all. COMPANY B is a business entity whose sole function is to own assets in order to protect COMPANY A from liability. It does not lease assets to anyone other than COMPANY A; in effect, the Taxpayers are leasing assets to themselves. It has no place of business other than an address. It has no employees. It has no assets other than the equipment it leases to COMPANY A. It serves no independent business purpose. COMPANY B is not a firm in the traditional meaning of the term. Again however, whether or not COMPANY B is a firm is not ultimately dispositive, since a firm cannot qualify for the tax incentive unless it has employees.

There is little basis to support the Division's position that, as a separate legal entity, COMPANY A cannot be a part of a firm. The circumstances involved with *SF Phosphates* are too specific and unique to be dispositive in this case. On the other hand, the Taxpayer has failed to define or establish a specific firm to which the credit might be available. The only entity that made an investment in manufacturing equipment was COMPANY B. COMPANY A is either a firm that has no employees, or else a different type of business entity for which the credit is not available. An individual taxpayer or business entity may not claim the credit on behalf of a firm under § 63-38f- 413 if that firm does not qualify for the credit under § 63-38f-412 in the first place. The firm that hired the employees or made an investment is the only entity whose credit may be claimed by a related business entity.

If COMPANY A had purchased the equipment directly there is no question that it would have qualified for the credit. However, the Taxpayers, for their own reasons, decided to set up a separate LLC,

5 The references to "business firm" in § 63-38f-412 refers to the type of firm, as opposed to a law firm or another type of firm.

through which the equipment was purchased and then leased back to COMPANY A. The Taxpayers might also have set up COMPANY B LLC with COMPANY A as the owner. Another option would have been to have had one employee employed by COMPANY B. Any of these options would have qualified COMPANY B for the credit.

In summary, there is no basis for COMPANY B to qualify for the credit. Nonetheless, in spite of the requirements of strict construction against granting credits, and of giving words their plain unambiguous meaning, the language in the statute could be extremely confusing to a taxpayer. For the Taxpayers to consider all of their LLC's to function as a single business firm, and therefore to qualify for the applicable credits, including the investment credit for COMPANY C, is understandable.

Accordingly, for this reason, disallowing the credit should be prospective; the audit should be abated for the 2005 tax year. Any subsequent application of this ruling, had it been the majority, would have been moot; the statute was changed in 2006.

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. Sec. 63G-4-302. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Sec. 59-1-601 et seq. and 63G-4-401 et seq.
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